No. 12,965

IN THE

United States Court of Appeals
For the Ninth Circuit

Hawaiian Freight Forwarders, Ltd., *Petitioner,* vs. Commissioner of Internal Revenue, *Respondent.*	

REPLY BRIEF FOR THE PETITIONER.

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PRELIMINARY STATEMENT.

Respondent is to be congratulated in that his argument, at least in part, reduces the controversy in main to what at all times has been the basic issue presented. While this issue is not clearly stated in the respondent's brief, it is implicit throughout:

> Was a new partnership created by the withdrawal of Dr. Schnack, and if so, is petitioner precluded from using the earnings experience of the predecessor partnership? (Compare Stipulation Par. 13, Tr. 37.)

On the other hand, at least in part, respondent endeavors to confuse this issue, or at least, his brief has that consequence. He nowhere discusses the law

most pertinent to this issue, the law of Hawaii. He nowhere discusses the basic remedial purpose of Congress in enacting Supplement A. He attempts to beg the question throughout by referring to the partnership, not by name, but in terms of "the Leffel-Ballentyne-Schnack Partnership" and "the Leffel-Ballentyne Partnership", and nowhere does he attempt to really discuss or answer the basic question answered so definitely and clearly in the case of *Ransohoffs, Inc. v. Commissioner,* 9 T.C. 376; i.e., whether under local law or for the purposes of the taxing act, the same partnership continued or a new partnership was created.

As did the Tax Court, he practically ignores the stipulated fact that from and after the date of Schnack's withdrawal Leffel and Ballentyne *were equal partners,* not joint proprietors (Tr. 33). He ignores, also, the pertinent language in Exhibit A-1 (Tr. 39) which clearly establishes that the partnership *was* to be continued by Leffel and Ballentyne pursuant to written agreement between themselves and Dr. Schnack, at least for the period required to complete the business in progress and to effect the transfer of assets to the corporation.

He admits that the Tax Court never reached this fundamental issue (Br. p. 17, footnote 5). He impliedly admits, by failure to argue the point, that the Tax Court's conclusion was contrary to the stipulated facts and the documentary exhibits. Those facts incontrovertibly establish that the partnership *was intended to continue* and that *it did continue,* at least

from March 8 to April 1, and under the law of the Territory, until July 2, 1940.

The respondent thus admits that the Tax Court never decided the case presented to it and, inferentially, that it decided a controversy never presented to it.

The respondent's argument is technical but his technicalities are fictitious, not real. He fails to discuss the true technical aspects. The most pertinent regulation is nowhere discussed:

> "* * * a partnership (or a business owned by a sole proprietorship) cannot be an acquiring corporation."

Petitioners submits that these words have no reference to a readjustment of partnership interests in a continuing venture, but taken in their context and ordinary meaning are concerned with actual, not fictitious or technical acquisitions by one partnership of the properties of what was clearly in substance a distinct entity. The reasonableness of this interpretation is particularly evident if we consider the broad remedial purpose of Congress (nowhere discussed by respondent) in light of the basic purpose of the taxation of *excess* profits.

ARGUMENT.

I.

PETITIONER HAS MET THE REQUIREMENTS OF SECTION 740(a)(1)(D).

Respondent has accused petitioner's counsel of piecemeal, circuitous, reasoning, a criticism such counsel feels more strongly justified in the opposite direction. To more clearly show this the three subdivisions of the argument on the basic issue have been consolidated in this reply.

The cases cited by respondent on pages 14 and 15 of his brief in no way support his position. It is axiomatic that for a transaction to qualify under Section 112(b)(5) I.R.C. the transferors must have received stock of the transferee in proportion to the value of their respective interests in the property transferred as such value existed immediately prior to the transfer. There is no requirement that the interests or values shall have remained unchanged prior thereto.

The one way in which the requirements of Section 112(b)(5) could not have been met would have been if Leffel-Ballentyne and Schnack had received stock other than in proportion to *the value of* their interests in the partnership at the time of transfer. At that time the value of the interests was entirely in Leffel and Ballentyne. Respondent accedes that as concerns them the transaction with petitioner undoubtedly was a Section 112(b)(5) exchange (Br. 24).

Respondent thereby concedes that unless the "Leffel-Ballentyne-Schnack" partnership was termi-

mated by the readjustment of interests therein, there is no Section 112(b)(5) problem. His major premise, never stated but assumed, is that the readjustment of interests had that effect. Having so assumed he then argues that because the value of the interests of the partners was different prior to March 8, 1940, there was no Section 112(b)(5) transfer of *the partners'* prior interests in the properties.

The statutory language in Section 740(a)(1)(D) is not discussed by respondent. The pertinent language states that "a corporation which has acquired substantially *all the properties of a partnership* in an exchange to which Section 112(b)(5) * * * was applicable" will entitle the corporation to use the partnership experience. Respondent would change this to read, in part:

> "substantially the *properties of the partners* held in partnership without change in their proportionate ownership."

The respondent states (Br. 15) that Section 112(b)(5) relates to a transfer of property by *persons,* not by a juristic entity and that therefore Section 740(a)(1)(D) requires continuity of interest in the owners of the property. But, as will be shown, *the partnership owned* the properties (as contemplated by Congress), the partners owned their interests in the partnership. It was because of their interests in the partnership that they received (theoretically, at least, as a partnership distribution in kind) the stock of petitioner proportionate to the value of such interests in the partnership.

Respondent's assertion that Section 112(b)(5) refers to persons, not a juristic entity, is in any event completely false. "Person" and "persons" when used in that section have the meaning ascribed by the Internal Revenue Code. *Section 3797(a)(1)* provides:

> "Person. The term 'person' shall be construed to mean and include an individual, a trust, estate, partnership, company, or corporation."

American Compressor and Warehouse Co. v. Bender, 70 F. (2d) 655 (C.A. 5, 1934) and *United Carbon Co. v. Commissioner,* 90 F. (2d) 43 (C.A. 4, 1937) both cited by respondent, establish very clearly that the use of the word "persons" in Section 112(b)(5) is within the meaning ascribed to that term by the Internal Revenue Code and particularly by Section 3797(a)(1).

In both of these cited cases the transferors were corporations rather than natural persons and in *American Compressor and Warehouse Co.,* supra, the point is specifically decided contrary to the respondent's position.

Section 112(b)(5) is concerned with the *value* of interests and the cases therefore give full effect to equitable interests in existence before the transfer. In *Elmore Milling Co. v. Helvering,* 70 F. (2d) 736, 737, cited by respondent, the Court stated:

> "Certainly there was no express assignment, and if we consider the instructions with relation to the manner of issue of stock, contained in the offer, as an equitable assignment, we are unable to see whether it applied to the interest in the

> partnership or to the interest in the stock when issued by the Corporation."

In *Roberts Company, Inc.*, 5 T.C. 1, (1945) the four residuary legatees of an estate having equal interests therein organized a corporation to hold certain parcels of real property, they and their attorneys taking stock in varying percentages quite different from those held in the estate. The Tax Court held that there had been equitable assignments prior to the organization of the corporation and the transfer to it and that the stock received was substantially in proportion to the value of the interests of each in the property prior to the transfer.

In *F. G. Straubel*, 29 B.T.A. 516 (1933) it was held that a valid oral assignment of equitable interests had been made prior to transfer to a new corporation in exchange for its stock and that therefore the transaction met the test of Section 112(b)(5).

One of the leading tax authors has expressed a similar view. 3 *Mertens Law of Federal Income Taxation* 174. In his hypothetical case, A, B and C are equal partners in a partnership having assets of $100,000 and liabilities in the same amount. A and B desire to transfer the business to a corporation and provide additional capital, but C does not desire to participate. $50,000 of cash and the partnership properties are transferred to the corporation in exchange for stock issued equally to A and B and the assumption of the partnership liabilities. The author concludes that Sec. 112(b)(5) is applicable to this transaction.

In the same text at page 176, he suggests that in all instances in which one or more partners or co-adventurers do not desire to participate further and particularly in corporate form, the solution is acquisition of the dissenting interest prior to the transfer:

> "In that case the dissenting co-adventurers will of course, realize taxable gain or loss on their sale to the others but the latter will not have recognized gain or loss upon incorporation."[1]

The points above set forth in answer to the Respondent's contentions to a very substantial extent are a complete answer to the argument appearing on pages 17 to 19 of his brief. To a considerable extent, the respondent's confusion (and perhaps that of the Tax Court) comes from his use of labels and names which are distinctly meaningless and beg the question presented. Thus, it is only if we refer to a "Leffel-Ballentyne-Schnack Partnership" and later to a "Leffel-Ballentyne Partnership", that there is any implication that a new partnership was created rather than that the same partnership continued.

The respondent makes no argument, and offers no proof of any kind that a new partnership was created. Contrary to the documentary evidence and stipulated facts and contrary to the law of the Territory of Hawaii, he attempts to build an inference that

[1]Since a readjustment of partnership interests before incorporation from qualifying under I.R.C. Sec. 112(b) (5), it is obvious that the "dilemma" of which respondent is so proud, does not exist even on technical grounds. It goes without saying that such "dilemma" can not be even asserted on anything other than technical grounds.

Schnack's withdrawal created either a new partnership or a joint proprietorship.

He speaks of the petitioner being on either horn of a "dilemma", a dilemma which is purely fictitious unless Schnack's withdrawal had the effect which the respondent, without evidence and contrary to the evidence and to the law of the Territory states that it had of creating either a new partnership or a joint proprietorship. He does not attempt to answer the petitioner's evidence or arguments in this respect because he knows he cannot succeed in doing so; so he sets up a "dilemma" purely of his own making and which does not in any way exist.

Actually there is a dilemma in the proceeding, and not an artificial one either. The evidence and the law applicable thereto establish either:

1. The partnership of Ballentyne, Leffel and Schnack continued after March 8, 1940 but with Schnack having no interest in the properties, (as provided by Hawaiian law), or

2. The partnership continued in accordance with the agreement of the partners and as permitted under Hawaiian law with Leffel and Ballentyne as the sole and equal continuing partners.

3. The partnership ended on March 8, 1940 and petitioner acquired the business and properties of that partnership as of that date and with its stock issued pro-rata to the partners in accordance with their interests in the assets, giving effect to the readjustment of such interests immediately prior to the

transfer to petitioner. (As concluded by the Tax Court.)

In each instance petitioner comes squarely within the statutory language. It is not even necessary to give that statute the broad and liberal interpretation to be accorded a remedial measure. It is not even necessary to consider that the equities are entirely with petitioner, that the earnings of the business during the base period are a fair and just standard of the normal earnings thereafter.

Respondent's argument is in part inconsistent. He argues that a partnership is not a juristic entity for the purposes of Section 740(a)(1)(D) or Section 112(b)(5) but he also urges that the properties required must be those *of the partnership* which was in existence prior to December 31, 1939. If a partnership is to have properties belonging to it, it must be an entity at least for that purpose. This was certainly the view of Congress when it wrote the statute and used the language:

> "the properties *of a partnership*"

in Section 740(a)(1)(D).

In 1950 the Commissioner of Internal Rvenue reversed his prior position to admit that a partnership is an entity separate and apart from its members, so that a sale by a partner of his partnership interest is a sale of a single capital asset, not a sale of his interest in each partnership asset.

> *G.C.M. 26379,* 1950-1 C.B. 58.

This reversal accords with the position of the Tax Court and all Courts of Appeal which had passed on

the question (all but that for the First Circuit), many of which were cited and discussed in petitioner's brief—none in respondent's. *Section 51-3CCH page 3955.*

Once it is acceded that a partnership is an entity for one purpose, it can readily be appreciated it is not entirely a pluralistic concept. A change in membership does not necessarily create a new partnership.

Elder W. Marshall, 14 T.C. 90 affd. 185 F. (2d) 684 (C.A. 3, 1951);

Commissioner v. Sigvald Nielsen, 187 F. (2d) 233 (C.A. 9, 1951).

One of the most important things to note concerning the respondent's brief is negative. The respondent does not argue as the Tax Court erroneously concluded (without evidence, and contrary to the evidence):

> "Here there was no intention that the partnership should continue."

He relegates this conclusion of the Court to a footnote (Br. p. 17).

The evidence clearly discloses that Schnack withdrew on March 8, 1940, and under the agreement then made the remaining partners were to continue the partnership (at least until the business could be transferred to petitioner); that petitioner was not organized until six days after Schnack's withdrawal, and that the transfer of the *assets* to petitioner was not completed until April 1, 1940 (Tr. 34). During this interval of time, at least, there was an express agree-

ment to continue the business in partnership form and that agreement was followed.[2]

The interpretation that respondent gives to the opinion below makes more apparent sense than does that opinion (Br. 24). But from the foregoing reply to respondent's argument, coupled with his admission that the actual transfer was within Section 112(b)(5) it is clear that there never was any issue presented as to that section.

Respondent's position is that Section 112(b)(5) is an issue because (and only because) the partnership that had owned the assets went out of existence on March 8, 1940. This is apparent (though never fully stated) from his argument in general and in particular on page 24 of his brief where he admits the actual exchange was within the section.

But if this is true, the first point of inquiry must be, was there a termination of the partnership on March 8? If there was not, no 112(b)(5) problem exists. The respondent has admitted that this question was never reached by the Tax Court. Petitioner submits it has not been reached by respondent in his brief.

Respondent in no way points out the non-applicability of *Ransohoffs, Inc.*, 9 T.C. 376,[3] which is on "all

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[2]The Tax Court "presumed" that the business from March 8 was regarded as that of the corporation but stated its guess was not important (Tr. 50). The stipulated facts covered this point, especially paragraphs 13 (Tr. 37), 4 (Tr. 33) and 11 (Tr. 36), and Exhibit A-1 thereto (Tr. 37-39).

[3]A petition for review filed by the Commissioner in this Court was later dismissed and his prior non-acquiescence withdrawn, *1950-2 C.B. 4.* Respondent has therefore acceded to that decision as being correct.

fours" with the petitioner's case except that there the change in partnership membership occurred by death rather than by withdrawal, with continuation provided in the partnership agreement rather than in a supplemental agreement between the partners. Actually, the instant case is stronger for the taxpayer than the *Ransohoffs* case. The issue in that case as stated by the Commissioner was

> "Whether the partnership composed of Robert and James was actually in existence on August 1, 1936.[4] This presents on the facts of the case a cold question of law—the law of partnerships, governed by the law of the State of California."

In the *Ransohoffs* case, there had been a number of changes in the partnership from three to four to three and, finally, to two members. On May 20, 1938, a new partnership agreement was actually drawn, involving three partners, one of whom died on October 9, 1938. Under agreement of the partners, the partnership was continued. The findings of fact and opinion in the *Ransohoffs* case were by the full Tax Court of sixteen judges and there was no dissent. The Court looked both to the law of California and to Federal Tax Statutes and cases and found that, at least for the remedial purposes of Supplement A, the Ransohoff partnership had had a continuous existence. That is exactly the situation presented in the instant proceedings.

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[4]The applicable date in this proceeding is December 31, 1939. The principles involved are identical.

The respondent states that the case of *E. T. Renfro Drug Co. v. Commissioner,* 183 F. (2d) 846 (C.A. 5, 1950) is "on all fours" with the instant proceeding. While to us the strong dissent by Chief Judge Hutcheson is more persuasive and logical than the majority opinion, the case is by no means on all fours. It is clearly distinguishable on the following factors:

1. The law of the jurisdiction (Texas) apparently entailed a pluralistic concept of a partnership.

2. There were two major changes in the partnership, with Allen and Wren, both being eliminated as members.

3. This change was made several months before incorporation.

4. The managing partners were those that retired, the inactive investment partners remained.

5. There was no agreement or consent to continue the partnership.

6. There was a real issue on the question of whether "substantially all of the properties" were transferred.

7. There were several distinct partnerships and businesses involved.

Contrasted with the above, the instant proceeding involves:

1. Local law not only permitting but requiring partnership continuity until July, 1940, when the certificate of change was filed.

2. A single and minor change in the partnership interests.

3. This change was made shortly before incorporation.

4. No change was made in the management.

5. The partnership was continued by express agreement.

6. There is no issue on the "substantially all of the properties".

7. There is only a single partnership and business involved.

The Tax Court in deciding the *Renfro* case found the *Ransohoffs* case clearly distinguishable, and in particular emphasizes the Ransohoffs agreement that the partnership should continue.

E. T. Renfro Drug Co., 11 T.C. 994, 998.

So here does petitioner. That Court also emphasized the fact that of total assets of $138,725 held by the Renfro partnership, $63,000 of inventory and receivables *were not transferred* to the corporation. These were clearly business "properties" of the partnerships.

While the decision in the *Renfro* case may be regarded as debatable (certainly Judge Leech of the Tax Court and Chief Judge Hutcheson of the Court of Appeals for the Fifth Circuit so regard it) the decision in the *Ransohoffs* case is clearly sound and correct (as witnessed by the concurrence of the entire Tax Court, the dismissal of the Commissioner's petition for review, and his acquiescence in the decision).

Respondent has entirely failed to distinguish the *Ransohoffs* case, *supra.* The case herein presented is actually stronger than the *Ransohoffs* case:

1. The partnership withdrawal here was of a minority partner.

2. This partner took no part in partnership affairs.

3. Only one change was made in the partnership organization and no new agreement of partnership was made.

4. The continuity of the partnership was not only permitted it was required by local law and in far more direct and definite fashion.

5. All interested persons consented to the continuation of the partnership by Ballentyne and Leffel.

Under the law of Hawaii, a partnership is treated basically as an entity, far more so than under the Uniform Partnership Act involved in *Ransohoffs, supra.* The following quotations and notes from *Revised Laws of Hawaii 1945* establish this:

1. "The real property shall be assessed in its entirety to the owners thereof. * * *" *Sec. 5141.* "Property of a corporation or a partnership shall be assessed to it under its corporate or firm name." *Sec. 5142, Sec. 5637* (Personal Property Tax.)

2. "*'Employer'* shall include any individual, person, trust estate, decedent's estate, business trust, corporation, association, joint stock company, national bank, insurance company, partner-

ship or other entity * * *." *Sec. 5342* (Compensation Tax).

See also *Section 5371* (Consumption Tax), *Section 5401* (Fuel Tax), *Section 5442* (Gross Income Tax), *Section 5514, 5525* (Income Tax).

Particularly pertinent is *Section 12015 of the Revised Laws* as adopted in 1937:

> "*Continuance of Partnership.* When at the time of his death the decedent was a member of a partnership, and under the terms of the will of the decedent the executor is authorized to continue the business of the partnership or under the terms of the articles or agreement of partnership *provision is made for the continuance of the partnership* after the death of any partner or if it shall appear to the best interests of the estate, the executor or administrator may * * * *become or continue to be a special partner in the partnership* * * *." (Emphasis supplied.)

Partnership interests, notes, etc., are securities and the partnership is clearly an entity with respect to issuance of such securities under the Hawaiian "Blue Sky Law". *Sections 9101, 9107, 9111.* The last section refers to "changes in the personnel of a partnership" and "changes * * * in the copartners".

Under the laws of Hawaii, Schnack was still technically a partner and fully liable as such until a certificate of change in membership or dissolution was filed. *Revised Laws of Hawaii, 1945,* Sections 8604, 8605, 8609. This was not done until July 2, 1940 (Tr. 122). Until then Schnack remained a partner but

his interest in the partnership or in the properties had no value after March 8, 1940. Leffel and Ballentyne thereafter alone owned all partnership interests of value in equal shares and received petitioner's stock in equal shares for the properties of the partnership.

There was no new partnership, there was no joint proprietorship. There was a complete compliance with the statutory requirements—petitioner acquired "substantially all the properties of a partnership" in a transaction meeting the test of Section 112(b)(5) I.R.C.

II.

PETITIONER IS ENTITLED TO THE RETROACTIVE APPLICATION OF SECTION 740(a)(1)(D) FOR CREDIT CARRYOVER PURPOSES.

Respondent's argument on this issue is a recital of his regulations. He does not mention, however, his Regulation *T.D. 5391* as amended by *T.D. 5400* (See Appendix to Petitioner's Opening Brief). He does not mention the misleading acts of his agents on whom petitioner relied.

III.

THERE IS A REAL SUBSTANCE TO THE MISCELLANEOUS ERRORS OF THE TAX COURT.

A. Respondent states that the Tax Court summarized the facts in its opinion, but the Tax Court stated it made no findings other than "the facts as stipu-

lated are so found"; it expressly stated that it made no findings in its opinion (Tr. 87, 88, 113).

Respondent also is confused (Br. 24) as to what is a finding of basic fact and what is a conclusion of law.

B. Respondent asserts, but wholly fails to establish, that, principally, the statements of a factual nature by the Court have been distorted by petitioner. On this petitioner's counsel is content to stand on the record.

C. Petitioner accedes that the Tax Court *assumed* facts not in evidence, but contrary to all of the evidence if it did, as respondent states, assume that the transfer to petitioner was from the "Leffel-Ballentyne-Schnack" partnership with the interests of those partners then as they had been prior to March 8, 1940.

D. On this point respondent is quick to assert that what may have been completely illegal is a mere technicality. This reversal in respondent's position as to the importance of technicalities is somewhat amusing, but not entirely accurate. In addition to the factors mentioned in petitioner's brief (P. 53) Judge Van Fossan had heard and decided the *Ransohoffs* case, *supra,* a fact known to petitioners' counsel prior to the hearing, and was keenly aware of the close similarities presented (Tr. 72). They would not have escaped him as they did Judge Turner.

CONCLUSION.

Petitioner submits that the decision below is so clearly erroneous as to facts, law and procedure as to require reversal.

Dated, San Francisco, California,
December 28, 1951.

Respectfully submitted,
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